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Reduction of Dividend WHT (to 5%) under India-Netherlands DTAA as India abolishes DDT (from 1 April 2020)

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Tax-effective Dividend Distribution by Indian subsidiaries

One of the key features of India's Union Budget for 2020, presented by the Finance Minister on 1 February 2020, was the elimination of the intensely unpopular Dividend Distribution Tax ("DDT") with effect 1 April 2020 and a return to the "shareholder based taxation system" for dividends. The maneuverer is part of the policy package intended to position India as an attractive investment destination for foreign investors.

Old system (prior to 1 April 2020) - 20% tax leakage

DDT was first introduced in India in 1997 to encourage Indian companies to re-invest profits for expansion and growth, as well as to simplify collection of taxes on dividend. Under this system of dividend taxation, foreign shareholders were often unable to claim any double tax relief for the tax paid on dividend in India in their respective countries of residence because DDT was an indirect tax not covered in tax treaties. Hence, foreign shareholders (for instance, Dutch and U.K. companies) received dividends from Indian companies after deduction of about 20% DDT (15% plus surcharge and cess). The DDT applied over and above the tax Indian companies paid on profit (CIT) and was typically not creditable at the hand of the recipient companies. Therefore, DDT significantly lowered the rate of return on investments made by foreign companies.

New system with effect 1 April 2020 - benefit for foreign investors

With effect 1 April 2020, the Indian Income-Tax Act has been amended to effectuate the shift in taxation of dividends – from the distributing company to the recipient shareholder. Accordingly, dividends declared, distributed and paid by Indian companies, on or after 1 April 2020, will be taxed in the hands of the shareholders. Under the new system, Indian companies are obliged (in principle) to withhold 20% tax (plus the applicable surcharge and cess) from dividends paid to foreign shareholders, in accordance with domestic tax-law provisions. For non-resident shareholders, the dividends tax deducted at source (under domestic Indian law) is 21-22%. The key benefit of the new system of dividend taxation is that the withholding tax ("WHT") on dividends is covered in tax treaties (if the treaty provision is more beneficial compared to the domestic law). In other words, foreign companies in receipt of Indian dividends could consider availing lower WHT rates on dividends as prescribed under the applicable tax treaties.

Effective WHT rate & the relevance of MFN clauses

Based on Art. 10(2) of the India-Netherlands Double Taxation Avoidance Agreement ("DTAA"), India is (in principle) allowed to levy 15%[1] of the gross amount of the dividends distributed to a Dutch company. However, in Protocol IV no.2 of the DTAA, it has been agreed that, *"if, after the signing of this convention, under any Convention or Agreement between India and a third State which is a member of the OECD, India should limit its taxation at source on dividends to a rate lower or a scope more restricted than the rate or scope provided for in this Convention on the said items of income, then, as from the date on which the relevant Indian Convention or Agreement enters into force, the same rate or scope as provided for in that Convention or Agreement on the said items of income shall also apply under this Convention"*.

In this context, the India-Slovenia and the India-Germany DTAAs could be relied upon. Art. 10(2) of the India-Germany DTAA stipulates that India is (in principle) allowed to levy 10% of the gross amount of the dividends distributed to a German company. This rate is further reduced to 5% under Art. 10(2)(a) of the India-Slovenia DTAA of 2005 for companies that directly own at least 10% of the Indian company paying the dividends. It should however be noted that the reduction to 5% only applies as from 1 June

[1] 10%, according to the information disclosed on the website of the Indian tax authorities. It could be that the Indian Government has applied the MFN clause in connection to the India-Germany DTAA.

2010, when Slovenia signed an Accession Agreement with the OECD. It should also be noted that the interplay with the MLI (signed by both, India and Slovenia) may require Dutch holding companies to satisfy a minimum holding period of one year in order to avail the favourable dividend WHT rate provided under the India-Slovenia DTAA.

For most Dutch companies, the dividends received (as well as capital gains realized) from Indian companies are exempt from Corporate Income Tax ("CIT") by virtue of the Netherlands' Participation Exemption (subject to satisfying the provisions thereof). In this respect, no credit is available for the 5% dividend WHT paid in India.

Availing treaty benefits

In order to avail the 5% WHT rate on dividends under the India-Netherlands DTAA, the Dutch shareholder in receipt of Indian dividends should (in principle) provide the Indian company distributing dividend with:

- a Tax Residency Certificate (certified by the Dutch tax authorities);
- completed Form 10F; and
- statement of beneficial ownership[2].

The requisite documentation should be provided to the Indian company before the dividend is declared, distributed or paid. If the Dutch shareholder is unable to provide the requisite documentation in time, a WHT of 20.80% to 21.84% (depending on the dividend amount) is levied by the distributing company. In such cases, the Dutch shareholder could consider applying to the Indian tax authorities for a refund of the excess tax withheld within a period of three years after the expiration of the calendar year in which the tax has been levied. (Reference is made to Protocol IV no.1 India-Netherlands DTAA)[3].

Attention points

In day-to-day advisory, caution is required while relying on MFN clauses due to their inter-dependence and complexity of language. Reference is made to the MFN clause in the Netherlands-RSA DTAA and our blog on this matter, dated 3 December 2019. Furthermore, countries tend to re-negotiate tax treaties to reflect their current and future economic policies (for instance, via protocols and the MLI; these alterations are not reflected in the main text of the original tax treaties). If, for instance, India re-negotiates its treaty with Slovenia or if Slovenia is no longer an OECD member, this might impact the applicable dividend WHT rate between India and the Netherlands.

Additionally, the dividend clauses in India's tax treaties with the Netherlands, Germany and Slovenia contain a beneficial ownership clause. Observing international developments, and in particular, the February 2018 Danish cases of the ECJ (that partly relate to beneficiary ownership of dividends/shares) as well as the interplay with MPTs, PPTs (via the MLI) and LoB provisions in the involved treaties, companies should consider aligning their holding structures with the underlying substance.

Negotiations between India and the Netherlands to amend the DTAA?

In early 2019, we have seen reports that India intends to amend the DTAA with the Netherlands, especially with regard to matters of capital gains taxation (following the suspension of the beneficial treatment granted to Mauritius and Singapore with respect to capital gains by successfully re-negotiating those DTAAs). In this context, it must be noted that, by virtue of Art. 13 of the India-Netherlands DTAA, the sale of unlisted shares of an Indian company is only taxable in India under limited circumstances. One of such circumstances is when the shares derive value from real estate in India, excluding real estate used for business (as per Art. 13(4) of the India-Netherlands DTAA). The DTAA (also) allows for the taxation of capital gains in India when 10% or more of an Indian firms' shares are sold to an Indian resident, but this comes with a big exception — such capital gains may be taxed in the Netherlands if the sale is part of a corporate restructuring (Art. 13(5) India-Netherlands DTAA). To this extent we expect amendments to the India-Netherlands DTAA. It is uncertain if and to what extent these amendments would impact the MFN clause and/or the beneficial treatment of dividends granted therein.

[2] In addition, the Indian company transferring funds abroad is required to submit to the tax authorities Form 15CA (self-declaration) and, if the payment is in excess of INR 500,000, also Form 15CB (certificate from a Chartered Accountant).

[3] It should, however, be noted that there is an Indian domestic tax-law limitation of one year from the end of the financial year for filing of the refund claim.

Impact Covid-19 lockdown & key-takeaways

- Due to the impact of the Covid-19 lockdown, companies may require repatriation of profits from India to non-resident companies in order to satisfy treasury demands. The elimination of DDT and the shift in taxation of dividends from the distributing company to the recipient shareholder, with effect 1 April 2020, may enable repatriation of profits from India to the Netherlands with limited cash leakage (5-6%). In terms of tax/cash savings, this is a net benefit of 15-16% of the gross amount of dividends distributed before and after 1 April 2020.

- Availing the lower WHT rate on dividends in accordance with the India-Netherlands DTAA is subject to the provision of the requisite documentation: TRC, Form 10F and a declaration of beneficial ownership. If the requisite documentation is not provided in time by the Dutch company, the Indian company distributing the dividend is obliged to withhold (effectively) 21-22% of the dividend paid out, in accordance with the domestic WHT rate on dividends.

- In such case, the Dutch shareholder could claim a refund within a period of three years after the expiration of the calendar year in which the tax has been levied[4]. The refund process may, however, take some time, is not guaranteed to yield the desired result, and may not be preferred from a treasury point of view. Observing the impact of the Covid-19 lockdown on businesses and the resulting drop in reported profits, it could be that the Indian tax authorities discuss/challenge a claim for refund.

- In addition, we expect amendments to the India-Netherlands DTAA, especially with regard to the beneficial treatment of capital gains. It is uncertain if and to what extent these amendments would impact the MFN clause and/or the beneficial treatment of dividends granted therein.

DISCLAIMER

In this blog we have commented on the legal interpretation of tax treaties. It should be noted that in the context of base erosion and profit shifting, it is recommend to embed legal ownership with economic rationale. In addition, and observing internal developments in view of the Danish cases of the European Court of Justice (C-115/16, 116/16, C-117/16, C-118/16, C-119/16 & C-299/16), as well as the ratification of the Multilateral Instrument, concepts such as 'beneficial ownership' and 'abuse of law' should also be considered. Reference is made to the specific indications presented by the ECJ in the Danish cases that could lead to the conclusion that there is an abuse of law. It is recommend to discuss this, in advance, with a local Indian and Dutch counsel.

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[4] It should, however, be noted that there is an Indian domestic tax-law limitation of one year from the end of the financial year for filing of the refund claim.

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